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SEC Investigates Six Companies On Pension, Benefit Accounting

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The Securities and Exchange Commission is investigating whether six large companies could have manipulated earnings by using certain assumptions to calculate liabilities and costs for pensions and retiree health benefits.

A spokesman for the SEC stressed that the agency has no evidence of violations but added that the companies, which he didn't identify, weren't selected at random. The inquiry focuses on assumptions companies use to calculate current pension expenses, which can have an effect on income. The inquiry was reported last week by BusinessWeek magazine.


The SEC also says it is examining how changes in benefits plans can create "cookie jar" reserves to boost earnings. There has been growing concern that large U.S. companies have been using their benefits plans for many years to enhance income and mislead shareholders in various ways. Benefits plans are among the areas the SEC's enforcement division is scrutinizing under its new "risk based" initiative to identify emerging areas of possible accounting fraud.

In recent years there has been growing criticism that companies are using artificially high estimated rates of returns on pension assets to lower their current pension costs. (The "cost" is the amount that gets included in quarterly calculations that show the impact of the pension plan on the company's income.)

Under standard accounting practices, companies don't use the actual returns on their pension assets to calculate costs, because this could lead to large swings in results from year to year. Rather, they use "expected returns." In the 1990s, companies used expected rates of about 10%, even though their actual returns were 20% or more. In recent years, some companies have continued to use rates of around 8%, even though their actual returns were significantly lower.

Regulators also are examining the discount rate used to calculate future pension liabilities. Employers typically use a rate based on high-grade corporate bonds to calculate their benefits liabilities (the amount they expect to pay during the lives of current and future retirees). A change of one-half percentage point can

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produce a \$1 billion swing in a large pension plan.

One concern is that companies may be tempted to use unrealistically high discount rates to lower their liabilities, to make their balance sheet look better and to generate accounting gains that boost income, and thus, executives' pay. Alternatively, companies can jack up liabilities prior to union negotiations or bankruptcy filings.

The SEC has issued guidelines on the correct range of assumptions, but companies have leeway about the use of these assumptions.

The SEC also confirmed that it is examining another area with potential for abuse: the use of assumptions in retiree health plans to affect earnings.

Companies have more opportunities to raise or lower the liabilities and costs for retiree health plans, because in addition to the discount rate they also use a "health care trend" assumption. This isn't an actual measure of inflation in the cost of hospital stays, premiums or prescription drugs. Rather, it is a company's estimate of future inflation, based on many undisclosed measures.

Some critics worry that companies use unrealistically low inflation assumptions. But a single-digit inflation figure isn't necessarily a sign of financial game-playing, because half of large companies have adopted caps on future spending, so they face little exposure to rising health-care costs.

However, employers do have significant incentives to inflate their health-care liabilities. Employers can easily increase these liabilities by adopting high inflation assumptions and low discount rates. Then, by changing the assumptions and cutting benefits (which is easier to do than with pensions), they can generate accounting gains that can be used to boost income in a particular quarter, or stockpiled for use later.

The kind of accounting gimmickry that the SEC is looking for doesn't have anything to do with a company's decision to fund its pension plan. Companies use different calculations under pension laws to determine whether they need to contribute to their pension plans.

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